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IN THE

Supreme Court of the United States

October Term, 1967

No. 1148

WALTER E. HELLER AND COMPANY

Petitioner,

v.

CHARLES C. SHAW, Trustee in Bankruptcy for BEMPORAD CARPET MILLS, INC.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Of Counsel:

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in the above-entitled case on November 27, 1967.

CITATIONS TO OPINIONS BELOW

The opinion of the Court of Appeals, printed in Appendix A attached to this petition, *infra,* pp. A1-A12, is reported in 385 F.2d 353. The opinion of the United States District Court for the Northern District of Georgia printed in Appendix A, A13-A33, is reported in 258 F. Supp. 394.

JURISDICTIONS

(i) The judgment of the Court of Appeals was entered on September 14, 1967 (R. 210-21).

(ii) Rehearing was denied on November 27, 1967 (R. 267-70).

(iii) The jurisdiction of this Court is invoked under 28 U.S.C.A. § 1254(1).

QUESTION PRESENTED

Is a set off by a factoring company within four months of bankruptcy against a reserve account maintained by that company, a transfer of the bankrupt's property within the meaning of section 60a of the Bankruptcy Act, 11 U.S.C.A. § 96a.

STATUTES INVOLVED

The statutory provisions involved are § 60a of the Bankruptcy Act, 11 U.S.C.A. § 96a; § 60b of the Bankruptcy Act, 11 U.S.C.A. § 96b; and § 68a of the Bankruptcy Act, 11 U.S.C.A. § 108a. These sections are printed in Appendix B, *infra*, pp. B1-B2.

STATEMENT

The trustee in bankruptcy of Bemporad Carpet Mills, Inc., (Bemporad) brought an action in the district court against Walter E. Heller and Company (Heller) to recover approximately $287,000 of alleged preferential transfers arising out of a traditional factoring arrangement (R. 9-11). The district court in holding that Heller received no preferential transfers set forth detailed findings of fact and conclusions of law (Appendix A, *infra*, pp. A13-A34).[1] The Court of

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[1]Appendix A is hereinafter cited only to the page number.

Appeals for the Fifth Circuit reversed; a rehearing was denied on November 27, 1967 by a written opinion (A1-A12).

For eighteen months prior to bankruptcy Heller purchased accounts receivable from Bemporad under a factoring contract (A14). The transfers of accounts were perfected in accordance with applicable state law at or prior to the time of the transfer, and the question of perfection was not controverted nor is it an issue in the case. Under the factoring contract, Heller concurrently with the assignment of each account became obligated to pay a fixed purchase price at a fixed time (R. 198). The credit risk on each account was assumed by Heller (R. 198-99). Heller maintained a factoring reserve which represented the indebtedness owed by Heller to Bemporad on the purchase of the accounts.

Bemporad on its own credit was unable to acquire the bulk of its manufacturing inventory (A18, A23-A24). Before and during the four-months period immediately preceding bankruptcy, in order to obtain this inventory, Bemporad directed Heller to guarantee payment to suppliers of that inventory (A18). Immediately prior to shipment Heller guaranteed payment to the suppliers.[2] Each time Heller made a guaranty the factoring reserve was sufficient to cover the amount

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[2]The transactions were of two types. With respect to four of the suppliers, Heller first guaranteed payment and subsequently purchased the account receivable. These four suppliers were factoring customers of Heller and sold accounts receivable to Heller under a factoring contract virtually identical to Bemporad. With respect to one supplier, duPont, Heller did not purchase the accounts receivable upon which it had guaranteed payment.

of the guaranty. These transactions created a debt from Bemporad to Heller.

In due course after each payment to a supplier Heller set off its debt to Bemporad represented by the factoring reserve against the debt of Bemporad to Heller resulting from Heller's guaranties and payments to those suppliers (A19). Each set off was effected by a charge against the factoring reserve as contemplated and authorized by the factoring contract (R. 199). At the time of each set off the factoring reserve was sufficient to cover the amount of the set off.

These set offs against the factoring reserve are the transfers which the Trustee alleged and the Fifth Circuit held to be voidable preferences.

The basis of the Fifth Circuit's opinion is that while there were in existence debts of Bemporad to Heller arising from the guaranties, Heller received collections on the assigned accounts and made set offs against the factoring reserve. The court reasoned that these debts were "antecedent" to the collections and set offs, a fact which Heller had stipulated,[3] and concluded that

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[3]Originally the Fifth Circuit held that Heller had stipulated that the transfers of the accounts receivable were for an antecedent debt (A4). Heller's motion for rehearing vehemently attacked this interpretation of the stipulation (R. 223-52). Heller, in that motion, conceded that it had stipulated that the *charge* against the factoring reserve was to satisfy an antecedent debt (R. 225). The Fifth Circuit's opinion, in response to Heller's motion, denied that its opinion was based on a stipulation that the accounts receivable were transferred for an antecedent debt, (A11), but said that the "payments" (charge against the factoring reserve) "did relate back to the delivery over of the accounts" (A11-A12).

the collections and set offs were transfers for an antecedent debt.

The court then ruled that the collections and set offs were used to satisfy then existing debts and this "relate[d] back" and tainted the original underlying assignment of the accounts receivable making the assignment of the account a transfer for an antecedent debt. This decision was reached notwithstanding the uncontroverted fact that the accounts were assigned and transferred before the debts which were satisfied arose. Thus, in effect, the Fifth Circuit treated as decisive the time when the accounts were *collected* instead of the time when the accounts were *assigned*.

REASONS FOR GRANTING THE WRIT

I. The Fifth Circuit's Decision Conflicts With Decisions in Other Circuits Holding Set Offs Against Reserve Accounts Valid.

Section 68a of the Bankruptcy Act, 11 U.S.C.A. § 108a, permits a creditor of the bankrupt to set off against the bankrupt's debt any indebtedness owed by that creditor to the bankrupt. This provides a preference for a creditor over other creditors who do not have the availability of set off. Nevertheless, this type of preference is clearly sanctioned by this Court and by recognized authorities.[4]

(a) The decision of the Fifth Circuit in the present case is in direct conflict with *First Nat'l Bank v. Julian,*

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[4]See *New York County Nat'l Bank v. Massey,* 192 U.S. 138, 147 (1904); 4 W. COLLIER 68.16, at 778 (14th ed. 1967); 3 REMINGTON, BANKRUPTCY ¶ 1434, at 376-77 (5th ed. repl. vol. 1957). One commentator has characterized a section 68a transfer of property as a "legal preference." 3 W. COLLIER ¶60.15, at 827 (14th ed. 1967).

383 F.2d 329 (8th Cir.) *cert. denied,* 88 Sup. Ct. 593 (1967) which held that a creditor could set off against a reserve account other indebtedness owed by an insolvent to that creditor. In *Julian* an automobile dealer was selling his retail automobile paper to a bank. The reserve account was created in large part by the dealer having to deposit the difference in the interest it paid to the bank and the interest it charged to its customer. The Eighth Circuit held that the charge against the reserve account was not a transfer of property that constituted a voidable preference. By so holding, the Eighth Circuit recognized the legitimacy of a reserve account which the Fifth Circuit has denied. In the present case the Fifth Circuit found the charge by Heller against the factoring reserve account to be a voidable preference. The Fifth Circuit's position is in direct conflict with that of the Eighth Circuit.

(b) The decision of the Fifth Circuit is also in direct conflict with the Second Circuit's decision in *Wolf v. Aero Factor's Corp.*, 221 F.2d 291 (2d Cir. 1955), *affirming* 126 F. Supp. 872 (S.D.N.Y. 1954). In Wolf, the finance company which was lending on the security of accounts receivable would only advance 80 per cent on those receivables and retained 20 per cent.[5] The

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[5]There is basic distinction between factoring and accounts receivable financing. In factoring the person who acquires the accounts actually purchases them and by doing so assumes the *credit risk* of the debtors on the account. In accounts receivable financing, no credit risk is assumed; there is only a *loan* on the *security* of the assigned accounts. In *Wolf v. Aero Factor's Corp.*, 221 F.2d 291 (2d. Cir. 1955, *affirming* 126 F. Supp. 872 (S.D.N.Y. 1954), the court held that the creditor there involved, was not factoring, but was lending on the security of assigned accounts. See 126 F. Supp. at 882. For a general discussion of the distinction between factoring and accounts receivable financing see 1

Second Circuit held that the creditor could set off the funds it had collected (in what was tantamount to a 20 per cent reserve) and therefore owed to the bankrupt, against other indebtedness owed by the bankrupt to the creditor. See *Wolf v. Aero Factor's Corp.*, 126 F. Supp. 882-84 (S.D.N.Y. 1954), *aff'd*, 221 F.2d 291 (2d Cir. 1955).

(c) The decision in the present case is in direct conflict with the implied holding in *Porter v. Strevell-Paterson Fin. Corp.*, 292 F.2d 706 (10th Cir. 1961). In *Porter*, the trustee attacked the charge against a reserve account on the grounds that the finance company had not given him notice or demand for payment before setting off but the Tenth Circuit held that the finance company did not have to give such notice and left the set off standing as valid.

(d) The decision in the present case also conflicts with a well-reasoned and comprehensive opinion by a district court in the Ninth Circuit, *Pasadena Investment Co. v. Pasadena Air Prods. Inc.*, 234 F. Supp. 128 (S.D. Cal. 1964). While *Pasadena* is not a circuit court decision its fine analysis and similarity to the present case justifies bringing it to this Court's attention. In *Pasadena*, the bankrupt held contracts with two aircraft manufacturers. A factoring company agreed to purchase from the bankrupt all of the bankrupt's acceptable accounts receivable and in the process, purchased accounts receivable owing by the aircraft companies to the bankrupt. The court held that although the factoring company had advanced to the bankrupt

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G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 5.1-5.2 at 132 (1965); *Silbert Financing and Factoring Accounts Receivable*, 30 HARV. BUS. REV. 39, 41 (1952).

funds in excess of the amount then standing in the reserve account, thus putting the bankrupt in an overdrawn position, even this did not create an antecedent debt which would upon satisfaction be a preference because the finance company "being a debtor, could apply such amount of overdrafts as advancements upon future purchases under the continuing mutual factoring agreement." 234 F. Supp. at 134-35.

The decisions in the four circuits permitting a set off against a factoring reserve are in line with a host of decisions which have permitted a bank to set off under section 68a an insolvent's deposit against a debt owed to the bank by a bankrupt. See *e.g., New York County Nat'l Bank v. Massey,* 192 U.S. 138 (1904); *Citizens Nat'l Bank v. Lineberger,* 45 F.2d 522, 529-31 (4th Cir. 1930). A reserve account for the purposes of set off is essentially equivalent to a bank deposit; both are debts owed by the creditor the the bankrupt. None of those cases has questioned the right of the creditor to set off where it is clear that the creditor's debt is a genuine debt and not merely a masquerade for an unlawful payment by the bankrupt. In other words, in the bank cases, if the bankrupt made a genuine deposit which established a genuine debtor-creditor relationship between the bank and the bankrupt, set off is permitted. Set off will be denied, however, if the court finds that the transfer to the bank was not a genuine deposit but merely a payment. See *Blue v. Herkimer Nat'l Bank,* 30 F.2d 256, 259 (2d Cir. 1929), *cert. denied,* 281 U.S. 750 (1930).

The Fifth Circuit found that antecedent debts were paid by the transfer of accounts receivable rather than extinguished by a set off against a factoring re-

serve.[6] To reach this result the court said that the payments did "relate back to the delivery over of the accounts" (A12). Consequently, the Fifth Circuit found a payment for an antecedent debt rather than a valid factoring reserve even though there was no evidence in the record to suggest that the factoring reserve was not bona fide. Therefore, the holding that Heller was not entitled to set off its debt represented by the factoring reserve, which was a valid and bona fide debt, brings the present case into direct conflict with those circuits which have allowed set offs against valid reserve accounts.

At the heart of the Fifth Circuit's error is its insistence on treating the collections of the accounts receivable as the controlling incident in the entire transaction. This holding is contrary to existing law; where there is a valid assignment of accounts receivable collections on those accounts are not preferential. See *Sexton v. Kessler & Co.*, 225 U.S. 90 (1912); *Hughes v. Lawyers, Trust Co.*, 108 F.2d 792 (2d Cir. 1940); 3 W. COLLIER ¶ 60.48, at 1016 (14th ed. 1967).

Even if Heller had not collected one penny on the accounts assigned to it Heller would have still been

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[6]The Fifth Circuit in its original opinion seemed to indicate that Heller was arguing that even though Heller had received a voidable preference it could set off the amount of the bankrupt's debt against the Trustee's action to recover that voidable preference (A6-A7). Heller had never made this contention. However, in its opinion in response to Heller's motion for rehearing the court held that "by paying antecedent debts with accounts previously assigned to it [this is the setting off against the reserve account] Heller completed a transaction resulting in a voidable preference and hence was precluded from claiming a right of set off against the Trustee" (A12).

obligated to pay Bemporad for the accounts receivable which Heller had purchased. However, Heller would have also been able to set off its obligation represented by the factoring reserve against Bemporad's debt to it arising from the guaranties to the suppliers. In this connection it is important to realize that the factoring reserve was not comprised of collections. The collections on the accounts were irrelevant to a determination of the legitimacy of charges against the factoring reserve. Nevertheless, the Fifth Circuit, in an unprecedented holding, separated an account from the proceeds of that account, made the time of collection the determining factor in the case and thus invalidated an otherwise valid factoring reserve. In all of the four cases cited in this petition where the different circuits involved upheld the validity of charges against reserve accounts, the collections, just as in the present case, were subsequent to the creation of the bankrupt's debt and in none of those cases was that point controlling nor even discussed. The Fifth Circuit's decision in this case is clearly an aberation.

II. The Fifth Circuit's Decision Could Substantially Reduce the Availability of Factoring As a Source of Funds and It Produces Uncertainty in Conventional Commercial Relationships.

The total amount of factoring in the United States for the year 1967 was $8.993 billion dollars. *Daily News Record,* Feb. 5, 1968, at 1. (Fairchild Publication, New York, New York). Factoring had its origin in the textile industry. See Fig. I G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 5.1, 5.2, at 128-53 (1965). The factor was a significant element in that industry because "the small textile manufacturer has always needed financing and has always looked like

an unattractive risk to the banker." *Id* at 130. See generally Silbert, *Financing and Factoring Account Receivable,* 30 HARV. BUS. REV. 39 (1952). The factoring concern is obviously a substantial adjunct to the commercial finance industry and is principally used by small or moderate size businesses. The present decision if uncorrected could severely limit the availability of factoring as a source of funds for these businessmen.

The Fifth Circuit's decision also interjects uncertainty into established commercial practices. By holding that the time of collection of the account receivable establishes the time when the account is transferred the Fifth Circuit assumes a position contrary to section 9-106 of the *Uniform Commercial Code* (enacted in all states but Louisiana) which provides in part that "an 'account' means any right to payment for goods sold ...." Therefore an assignment of an account includes an assignment of the proceeds. This court in *Bank of Marin v. England,* 385 U.S. 99 (1966) stated that it would be unequitable to hold a bank liable for accepting and paying a check when it had no knowledge of the intervening bankruptcy of its depositor. Similarly, it is equally inequitable and subversive of predictable commercial practices to hold, as does the Fifth Circuit, that Heller's rights on accounts receivable for which it is exchanging valuable consideration are not fixed until the accounts are collected at some time in the future.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,
CHARLES L. GOWEN
Counsel for petitioner.

February 21, 1968

CERTIFICATE OF SERVICE

I hereby certify that I have this day mailed a copy of the attached petition with appendices to Clinton J. Morgan, attorney for the Respondent, at his business address with sufficient postage attached this 22d day of February, 1968.

CHARLES L. GOWEN
Attorney for petitioner